

FISCAL NOTE

Bill #: SB0378 **Title:** Create certified capital company program
Primary Sponsor: Kitzenberg, S **Status:** As Introduced

Sponsor signature	Date	Chuck Swysgood, Budget Director	Date
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Fiscal Summary

	<u>FY 2004 Difference</u>	<u>FY 2005 Difference</u>
Expenditures:		
General Fund	\$37,000	\$11,800
State Special Revenue	\$37,500	\$112,500
Revenue:		
State Special Revenue	\$37,500	\$112,500
Net Impact on General Fund Balance:	(\$37,000)	(\$11,800)

<input type="checkbox"/> Significant Local Gov. Impact	<input checked="" type="checkbox"/> Technical Concerns
<input type="checkbox"/> Included in the Executive Budget	<input checked="" type="checkbox"/> Significant Long-Term Impacts
<input type="checkbox"/> Dedicated Revenue Form Attached	<input checked="" type="checkbox"/> Needs to be included in HB 2

Fiscal Analysis

ASSUMPTIONS:

1. This bill revises and clarifies the laws governing certified capital companies. Essentially, it reinstitutes a program that is very similar, but with modifications, to the capital company program that was initially put in place by the Legislature originally in 1983.
2. Under this bill, the Department of Commerce would certify capital companies whose primary business is to provide investment capital to qualifying businesses. Companies becoming certified capital companies would pay an initial application fee of \$7,500 to the Department of Commerce, and an annual certification fee of \$5,000 each year thereafter, as long as they remained a certified capital company.
3. A "person" could then apply to the Department of Commerce to become a "certified investor" by making a "certified capital investment" in the certified capital company. Individual investors could not own or control more than 10 percent of the interest in any single certified capital company.
4. Certified capital companies would make "qualified investments" in "qualified businesses" that could also be "certified qualified businesses" if certified by the Department of Commerce as being a qualified business. Qualified investments in a single qualified business cannot be more than 15 per cent of the total certified capital investments of the certified capital company.

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5. Persons making certified capital investments in a certified capital company would be entitled to a credit against individual income and corporation license taxes equal to 10 per cent of amount invested (see Technical Note #2).
6. The following table provides the history of the capital company credit initially enacted in 1983.

History of Montana Capital Company Credit 1983 to 2001							
Year	Credit % and Maximum	Individual Income Tax			Corporation License Tax		
		Number of Returns	Total Credit	Average Credit	Number of Returns	Total Credit	Average Credit
1983	25% up to \$25,000	83	15,561	187	n.a.	n.a.	n.a.
1984	25% up to \$25,000	117	28,466	243	n.a.	n.a.	n.a.
1985	25% up to \$25,000	165	61,530	373	n.a.	n.a.	n.a.
1986	25% up to \$25,000	124	77,962	629	n.a.	n.a.	n.a.
1987	50% up to \$150,000	220	463,711	2,108	n.a.	n.a.	n.a.
1988	50% up to \$150,000	217	1,056,439	4,868	n.a.	n.a.	n.a.
1989	50% up to \$150,000	181	1,490,748	8,236	50	82,912	1,658
1990	50% up to \$150,000	57	368,158	6,459	44	164,701	3,743
1991	50% up to \$150,000	48	177,469	3,697	58	73,597	1,269
1992	50% up to \$150,000	35	100,088	2,860	61	138,526	2,271
1993	50% up to \$150,000	28	143,216	5,115	56	199,525	3,563
1994	50% up to \$150,000	21	64,220	3,058	35	178,449	5,099
1995	50% up to \$150,000	45	892,516	19,834	50	159,661	3,193
1996	50% up to \$150,000	27	172,449	6,387	45	293,316	6,518
1997	50% up to \$150,000	11	146,035	13,276	49	223,028	4,552
1998	50% up to \$150,000	12	249,546	20,796	37	158,565	4,286
1999	50% up to \$150,000	8	190,146	23,768	30	62,112	2,070
2000	50% up to \$150,000	2	165,498	82,749	17	15,386	905
2001	50% up to \$150,000	3	170,001	56,667	15	9,047	603
Totals, 1987 - 2001:		915	5,850,240	6,394	547	1,758,825	3,215
Average Credit, 1987 - 2001:			390,016			135,294	

Over the period 1983 to 1986, the credit was equal to 25 per cent of the investment amount, up to a maximum of \$25,000. For tax years after 1986, the Legislature increased the credit to 50 per cent of the investment up to \$150,000.

7. This bill is effective July 1, 2003. Based on the history of the previous credit, it is likely that this bill will have a nominal impact in the 2005 biennium as it will take a couple of years to establish and certify capital companies, and provide the opportunity for certified investors to make capital investments in those companies. The initial tax effects would begin to show in FY 2005, but would be small. (See long-term impact section of this fiscal note for future impacts of this bill.)
8. There are no increases in Department of Revenue administrative costs associated with this bill.

Department of Commerce

9. SB 378 eliminates most of the current Montana Capital Company Act but retains the policy and purpose of the existing act.
10. The Department of Commerce will adopt rules establishing the procedures for becoming a certified capital company. The department will have 30 days to grant or deny the application.
11. Application Fees:
 - a. The non-refundable application fee that would be paid to the Department of Commerce is \$7,500.
 - b. The department estimates that there would be five applications in FY 2004 that would generate \$37,500 in application revenue

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- c. The department estimates that there would be five applications in FY 2005 that would generate \$37,500 in application revenue.

12. Annual Renewal Fees:

- a. An annual fee of \$5,000 will be paid each January by the Certified Capital Companies.
- b. Newly certified capital companies would not pay the first year's fee in January if they were certified within six months of that date.
- c. Annual renewal revenue is estimated to be \$0 in FY 2004.
- d. Annual renewal revenue is estimated to be \$35,000 in FY 2005.

13. Annual Compliance Review:

- a. The department will conduct an annual compliance review of each certified capital company. For each annual compliance review, the department may charge fees.
- b. The cost of each annual review is estimated to be \$5,000.
- c. No annual reviews would take place in FY 2004.
- d. Eight reviews would take place in FY 2005 generating \$40,000 in certification review revenue.
- e. The department assumes many of the annual reviews would be contracted.

- 14. One professional staff person in FY 2004 and 1.00 FTE administrative assistant would be added in FY 2005 to administer this new capital company act. Personal services costs are estimated to be \$49,500 in FY 2004 and \$94,300 in FY 2005. Operating costs are projected to be \$25,000 in FY 2004 and \$30,000 in FY 2005.

- 15. The maximum amount of investments that can be made in certified capital companies is \$50 million. Each investment in a certified capital company must be approved by the Department of Commerce before the investment is made and the department cannot certify more than \$50 million in investments.

FISCAL IMPACT:**Department of Commerce**

	<u>FY 2004</u> <u>Difference</u>	<u>FY 2005</u> <u>Difference</u>
FTE	1.00	2.00

Expenditures:

Personal Services	\$49,500	\$94,300
Operating Expenses	<u>25,000</u>	<u>30,000</u>
TOTAL	\$74,500	\$124,300

Funding of Expenditures:

General Fund (01)	\$37,000	\$11,800
State Special Revenue (02)	<u>37,500</u>	<u>112,500</u>
TOTAL	\$74,500	\$124,300

Revenues:

State Special Revenue (02)	\$37,500	\$112,500
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Net Impact to Fund Balance (Revenue minus Funding of Expenditures):

General Fund (01)	(\$37,000)	(\$11,800)
State Special Revenue (02)	0	0

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LONG-RANGE IMPACTS:

Department of Revenue

It is difficult to predict the long-term impacts of this bill on the state general fund. However, it is unlikely that this bill would reduce general fund revenues by more than \$200,000 to \$300,000 annually. Over the period 1987 to 2001, when the credit from the previous capital company program was equal to 50 percent of the investment up to a maximum credit of \$150,000, the average annual credit taken, including both individual income tax and corporation license tax, was \$525,000 (see above table showing history of old credit). Given that the new credit is equal to just 10 percent, rather than 50 percent, of the investment, it is reasonable to assume that the total credit taken in any year will, on average, be less than \$525,000, and will likely be closer to the range suggested above in this section.

TECHNICAL NOTES:

Department of Revenue

1. The bill provides that companies becoming certified capital companies would pay an initial application fee of \$7,500 to the Department of Commerce, and an annual certification fee of \$5,000 each year thereafter, as long as they remained a certified capital company. The bill is silent as to where these fees are to be deposited.
2. The 10 percent tax credit provided for in this bill is qualified by language stating that “The certified investor may claim either 10% of the certified investment or the amount by which the sum of the certified investor’s certified capital investments and the qualified investments exceeds the certified investor’s qualified investments in the tax year before the certified investor first claimed the credit under this section, whichever is less.” It is not clear what is intended with this language.

Department of Commerce

3. Section 1 (4) provides a confusing definition of “certified capital investment”. Its intent appears to be to define the initial investment by an investor in the certified capital company for tax credit purposes but uses the phrase “qualified business” instead. This creates the impression that an investment by a “certified investor” can be made directly into a “qualified business” as opposed to into the “certified capital company” under the new provisions. Section 1 (12) uses similar language to define a “qualified investment”, which is an investment in a “qualified business”. It is recommended that “qualified business” be replaced with “certified capital company” or that further clarification be provided.
4. It also is recommended that Section 1 (10) be clarified to state that a “qualified debt instrument” refers to a debt instrument issued by a certified capital company for the purposes of acquiring capital for reinvestment, as opposed to using debt to invest in a “qualified business”. It should also clarify whether a “qualified debt instrument” qualifies for tax credits.
5. The bill does not define a minimum investment into a certified capital company but defines a minimum financial position of a “person” to be eligible.
6. Section 4 refers to investments being made by a “certified capital company or any affiliate”. This section appears to provide for investments being made by affiliates. Section 1 includes numerous definitions and variations of “affiliate” making Section 4 unclear. It appears to allow for investment decisions to be made by a wide variety of entities and “persons” as opposed to an investment committee or board of the certified capital company.
 - a. For example, Section 1 (a) defines an affiliate as a person who controls or owns 10% or more of the certified capital company or certified investor. This appears to allow someone who owns or controls interests in a certified investor to make investments in qualified businesses. This is contrary to the rule that prohibits certified investors from having “control of the investments of the certified capital company.” in Section 3 (3).

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- b. Section 1 (b) defines an affiliate as a person that has 10% of control held by the certified capital company or certified investor. This appears to allow an individual or entity to make investment decisions even though they are partly owned and controlled by the certified capital company or certified investor. Section 1 (c) is even broader by saying that a person is an affiliate if “directly or indirectly controlling, controlled by, or under common control with the certified capital company or certified investor.”
 - c. Based on the definitions of “affiliate” in the statute, Section 4 is extremely difficult to enforce and to make determinations of what constitutes a “qualified business”. The definitions of “affiliate” appear to include many “persons” and/or entities that are not normally considered part of a corporation, partnership, limited liability company, etc.
 - d. Section 4 states that a certified capital company “may” request a written determination from the department regarding qualified businesses. This appears to be optional but binds the department to making a decision. In order to make a decision if the business is qualified at that time, there would need to be extensive financial and legal information submitted about the business and its “affiliates” and on all investors in the certified capital company and their business relationships. There is no time period specified for department review and decisions. Because of the broad definitions of “persons” and affiliates in the statute, this requirement would require extensive year-round staff review by persons highly qualified in securities, accounting, business law, and financial analysis.
- 7. If a certified capital company chooses not to have its investments pre-certified there is a significant burden placed annually on the department to conduct reviews and make determinations after the investments have been made.
 - 8. Section 11 states that if the certified capital company is in non-compliance, the certified investor can lose the tax credits. This is a significant disincentive to participate since the certified investor has no ability to manage the certified capital company and its investment decisions. It is not clear who enforces the recapture of those tax credits from the investor if there is non-compliance. There are no time periods or penalties related to this section beyond the recovery of the tax credits from the certified investors. No penalties appear to apply to the certified capital company.
 - 9. The fees proposed in SB 378 will not support the administrative costs of the program; therefore, general fund would be needed to fill in the revenue shortfalls.